

Tennessee State School Bond Authority

**For the Year Ended
June 30, 1998**

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September 29, 1999

The Honorable Don Sundquist, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable John G. Morgan
Comptroller of the Treasury
Secretary of the Tennessee State School Bond Authority
State Capitol
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee State School Bond Authority for the year ended June 30, 1998. You will note from the independent auditor's report that a qualified opinion was given on the fairness of the presentation of the financial statements. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter.

Consideration of internal control over financial reporting and tests of compliance disclosed certain deficiencies, which are detailed in the Results of the Audit section of this report. The authority's management has responded to the audit findings; the responses are included following each finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit findings.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/rm
98/120

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Tennessee State School Bond Authority
For the Year Ended June 30, 1998

AUDIT OBJECTIVES

The objectives of the audit were to consider the authority's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, and contracts; to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

INTERNAL CONTROL FINDINGS

Inadequate Accounting Procedures and Recordkeeping*

The authority does not have practical guidelines and procedures to ensure transactions are properly recorded. The many problems with the authority's financial statements contributed to the delay in completing the *Tennessee Comprehensive Annual Financial Report* (page 8).

Cash Reconciliations Not Properly Performed

The authority did not properly reconcile the cash accounts. As a result, the cash accounts contained several significant discrepancies. Also, the Statement of Cash Flows did not balance by \$205,603 (page 9).

Significant Discrepancies in the Schedule of Receivables and Supporting Documents

A review of the schedule of receivables revealed discrepancies between the schedule and the supporting documents and schedules. Also, numerous errors in the schedule of receivables and journal entries forced repeated revisions, resulting in lengthy delays and duplicated effort (page 10).

* This finding is repeated from the prior audit.

OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is qualified. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter.

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report which contains all findings, recommendations, and management comments, please contact

Comptroller of the Treasury, Division of State Audit
1500 James K. Polk Building, Nashville, TN 37243-0264
(615) 741-3697

Audit Report
Tennessee State School Bond Authority
For the Year Ended June 30, 1998

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Tennessee State School Bond Authority For the Year Ended June 30, 1998

INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Tennessee State School Bond Authority. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

LEGISLATIVE HISTORY

The Tennessee State School Bond Authority was established by the Tennessee State School Bond Authority Act, Chapter 256 of the Public Acts of 1965. As provided in this act, the authority is to act as a corporate governmental agency of the State of Tennessee for financing projects of the state’s higher education institutions. The authority is empowered to issue negotiable bonds and notes as a means of providing funds for financing approved projects. These projects include buildings, equipment, structures, and improvements. In 1980, the legislature amended the original act to include, as a project, a program for student loans. The amount of funds provided should be sufficient to cover the actual project costs, as well as the authority’s administrative expenses, including the cost of conducting the bond and note sales.

ORGANIZATION

The Tennessee State School Bond Authority consists of seven members: the Governor, the State Treasurer, the Secretary of State, the Commissioner of Finance and Administration, the Comptroller of the Treasury, the Chancellor of the Tennessee Board of Regents, and the President of the University of Tennessee. The Governor serves as chairman, and the Comptroller of the Treasury serves as secretary. The Director of the Division of Bond Finance serves as the assistant secretary; the division provides administrative and financial services to the Tennessee State School Bond Authority.

An organization chart for the authority is on the following page.

AUDIT SCOPE

The audit was limited to the period July 1, 1997, through June 30, 1998, and was conducted in accordance with generally accepted government auditing standards except as indicated in the Independent Auditor's Report. Financial statements are presented for the year ended June 30, 1998, and for comparative purposes, the year ended June 30, 1997. The Tennessee State School Bond Authority has been included as a component unit in the *Tennessee Comprehensive Annual Financial Report*.

The audit covered allotment code 307.07 – Division of Bond Finance (Fund 32).

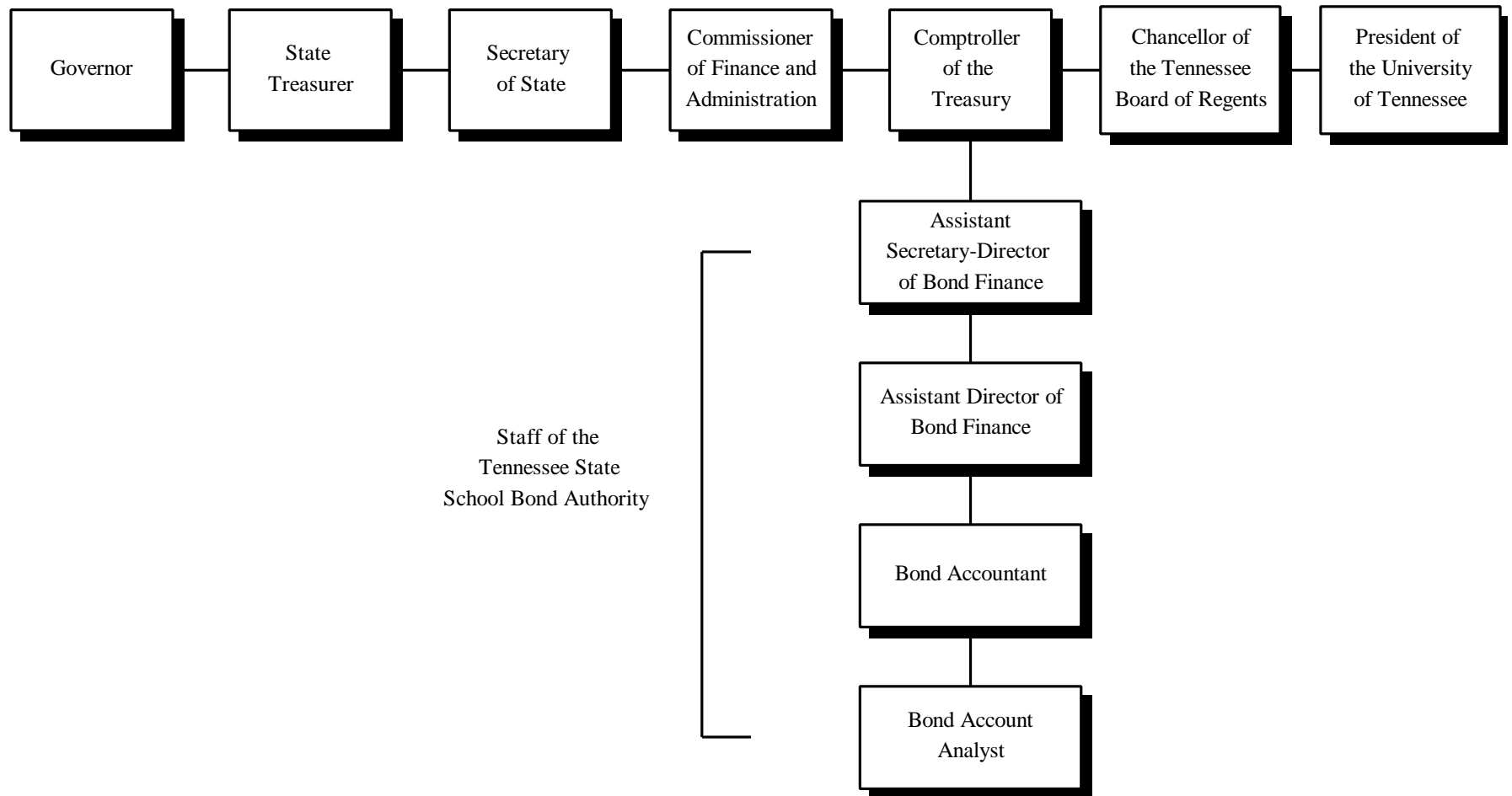
OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the authority's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;
2. to determine compliance with certain provisions of laws, regulations, and contracts;
3. to determine the fairness of the presentation of the financial statements; and
4. to recommend appropriate actions to correct any deficiencies.

Although this audit was not intended to serve as an organization-wide audit as described in the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, it included tests of compliance with applicable federal laws and regulations and consideration of internal control. This audit is a segment of the organization-wide audit of the State of Tennessee, which is conducted in accordance with the Single Audit Act.

TENNESSEE STATE SCHOOL BOND AUTHORITY ORGANIZATION CHART



PRIOR AUDIT FINDING

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Tennessee State School Bond Authority filed its report with the Department of Audit on August 19, 1998. A follow-up of the prior audit finding was conducted as part of the current audit.

REPEATED AUDIT FINDING

The prior audit report contained a finding concerning the lack of practical guidelines and procedures to ensure transactions are properly recorded. This finding has not been resolved and is repeated in this report.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the Tennessee State School Bond Authority's financial statements for the year ended June 30, 1998, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by generally accepted government auditing standards. Reportable conditions, along with recommendations and management's responses, are detailed in the findings and recommendations. Consideration of internal control over financial reporting disclosed no material weaknesses.

Compliance

The results of our audit tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Fairness of Financial Statement Presentation

The Division of State Audit has rendered a qualified opinion on the Tennessee State School Bond Authority's financial statements. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the authority's disclosures with respect to the year 2000 issue made in Note 7.

**Report on Compliance and on Internal Control
Over Financial Reporting Based on an Audit of
Financial Statements Performed in Accordance With
*Government Auditing Standards***

January 22, 1999

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the financial statements of the Tennessee State School Bond Authority, a component unit of the State of Tennessee, as of and for the year ended June 30, 1998, and have issued our report thereon dated January 22, 1999. Our report was qualified. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the authority's disclosures with respect to the year 2000 issue made in Note 7.

Except as discussed in the preceding paragraph, we conducted our audit in accordance with generally accepted government auditing standards.

Compliance

As part of obtaining reasonable assurance about whether the authority's financial statements are free of material misstatement, we performed tests of the authority's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and

accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the authority's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the authority's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

The following reportable conditions were noted:

- Accounting procedures and recordkeeping are inadequate.
- Cash reconciliations were not properly performed.
- The schedule of receivables and supporting documents contain significant discrepancies.

These conditions are described in the Findings and Recommendations section of this report.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control over financial reporting, which we have reported to the authority's management in a separate letter.

The Honorable John G. Morgan
January 22, 1999
Page Three

This report is intended solely for the information and use of the General Assembly of the State of Tennessee and management and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record, and its distribution is not limited.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/rm

FINDINGS AND RECOMMENDATIONS

1. Accounting procedures and recordkeeping are inadequate

Finding

As noted in the prior audit, the Tennessee State School Bond Authority does not have practical guidelines and procedures to ensure transactions are properly recorded. Management concurred with the prior finding and stated that they were “taking steps to document procedures for recording transactions and provide training to staff in the implementation of new Governmental Accounting Standards Board [GASB] statements related to accounting for debt.” However, procedures have not been documented, and the authority’s late and inaccurate financial statements indicate an unfamiliarity with the specialized accounting procedures applicable to the authority. As noted below, the authority had ample time to prepare for accounting changes had effective steps been taken by management.

- Although the Department of Finance and Administration (F&A) set a deadline of October 23, 1998, for delivery of completed financial statements, the first set of statements was not received until December 16, 1998. These statements, however, contained numerous calculation errors and material unsupported or unexplained numbers. After several revisions, the final balance sheet and operating statement were delivered January 11, 1999, and the final statement of cash flows, January 15, 1999. The many problems with the authority’s financial statements contributed to the delay in completing the *Tennessee Comprehensive Annual Financial Report*.
- A large number of material journal entries were proposed well past the cutoff date of September 11, 1998, established by F&A; the authority continued to submit entries until January 6, 1999. The total amount of entries on the State of Tennessee Accounting and Reporting System (STARS) made after the cutoff date exceeds \$90 million.
- The authority was notified in 1997 that GASB Statement 31, “Accounting and Financial Reporting for Certain Investments and for External Investment Pools,” would require that investments be reported at fair value beginning with the 1998 fiscal year. Between October 26, 1998, and January 5, 1999, the auditors received seven different fair value calculations and related journal entries—all of them incorrect.
- The auditors were advised to use STARS reports to prepare the working trial balance, although the STARS reports were incomplete and therefore inaccurate. Despite frequent requests from the auditors, some necessary STARS reports which were no longer available from F&A were not provided.

If the authority had developed guidelines and procedures as recommended in the prior audit, staff might have had less difficulty producing accurate and timely financial statements.

Recommendation

Management should establish adequate written policies and procedures to provide personnel with proper guidance for the accurate and timely recording of accounting transactions, to ensure the reliability of financial reporting. Management should take steps to ensure that appropriate personnel comply with these policies and procedures on a timely basis. Care should be taken when preparing documents and schedules to ensure their accuracy and timeliness.

Management's Comment

We concur. A change in staff occurred in March of 1998. At the time, management made the decision to split the job function as it was difficult to respond to all requirements of the then current job for both General Obligation and Tennessee State School Bond Authority debt in a timely manner. There was little time for transition training, and accounting was behind at that time. Even with the additional staff member, program considerations within the authority prevented the accountant from performing catch-up responsibilities. At this time, additional staff has been hired. Written policies and procedures have been prepared for most functions. Updating the policies and procedures is a continuing process that staff members perform whenever new issues arise. It appears that future financial statements will be timely.

2. Cash reconciliations were not properly performed

Finding

The authority did not properly reconcile the cash accounts. As a result, the cash accounts contained several significant discrepancies.

As a standard procedure, the auditors requested a reconciliation of the beginning cash balance in STARS to the ending balance, showing all increases and decreases in cash. Staff attempted such a reconciliation; however, not all increases and decreases could be accounted for. The auditors then attempted to prepare the reconciliation using supporting documentation for the transactions that processed during the year. However, the authority could not provide supporting documentation for a \$448,811 increase in cash on deposit with the State Treasurer and a \$10,263 increase in "cash with fiscal agent."

The reconciliation mentioned above is used in preparing the Statement of Cash Flows. However, the statement did not balance by \$205,603, and was adjusted. Part of the difficulty in reconciling cash was because the authority did not maintain adequate detailed financial information and because numerous entries were incorrectly made and then inaccurately reversed in the cash accounts in STARS.

The authority did not properly reconcile “cash with fiscal agent” in STARS to the bank statement. As a result, the authority’s balance sheet shows an amount of “cash with fiscal agent” that is \$133,281 less than the amount reported by the bank. Since the amount was not material to the financial statements, an adjusting entry was not made.

Accurate accounting for cash is necessary to provide confidence in the integrity of the financial statements.

Recommendation

Monthly reconciliations of the cash accounts should be performed to ensure that any problems or errors are discovered timely. Any discrepancies should be promptly investigated and resolved.

Management’s Comment

We concur. Following a previous recommendation, an additional staff member has been hired. Bank statements are being reconciled monthly. Furthermore, we are taking steps to assume more control over the allocation of interest revenue to the projects from the trustee. We believe that these steps will enable staff to perfect the cash reconciliation.

3. The schedule of receivables and supporting documents contain significant discrepancies

Finding

The authority maintains a schedule of receivables that shows the amounts due from the higher education institutions. This schedule also reconciles these receivable amounts with the total debt service due. A review of the schedule of receivables revealed discrepancies between the schedule of receivables and the supporting documents and schedules.

- Numerous errors in the schedule of receivables and journal entries forced repeated revisions, resulting in lengthy delays and duplicated effort. The auditors requested the schedule of receivables in June 1998. Between September 15, 1998, and January 12, 1999, ten different schedules of receivables—all of them incorrect—were given to the auditors.
- There was a \$214,748 difference between the total receivables reported on the final schedule of receivables and the total on the amortization schedules that reflect total debt service due. Authority personnel could not explain the difference.
- There was an \$11,885 difference between the unamortized cost of issuance reported on the schedule of receivables and the amount recorded in STARS.

- The debt service reserve amounts on the schedule of receivables are \$21,914 less than those on the bond payment schedules by project.

Management and staff of the authority had identified some of these differences prior to the audit.

Recommendation

The amortization schedules should be used as the basis for preparing the schedule of receivables. These schedules should be reconciled before final issuance of the schedule of receivables. Authority personnel should continue to investigate and correct the differences between the schedule of receivables and supporting documents.

Management's Comment

We concur. In the process of preparing for the audit, staff and management reported that there were discrepancies in the receivable report that should be corrected. Some of the discrepancies dated back 8-10 years. The time needed to correct the errors would have been extensive. We were advised to continue to use old numbers (which had not been corrected), perform consistent amortization calculations based on past years schedules, and make the corrections during the ensuing fiscal year. However, as the year-end process continued, several corrections were necessary and agreed to by the Department of Finance and Administration and by staff to close the year-end. At this time, the most egregious errors have been corrected. We are working to correct the receivable in the one remaining bond issue. The error does not appear to be material.

Auditor's Comment

We concur that the error does not appear material.

Independent Auditor's Report

January 22, 1999

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the accompanying balance sheets of the Tennessee State School Bond Authority, a component unit of the State of Tennessee, as of June 30, 1998, and June 30, 1997, and the related statements of revenues, expenses, and changes in retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the authority's management. Our responsibility is to express an opinion on these financial statements, based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the year 2000 issue. The authority has included such disclosures in Note 7. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully

The Honorable John G. Morgan
January 22, 1999
Page Two

determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the authority's disclosures with respect to the year 2000 issue made in Note 7. Further, we do not provide assurance that the authority is or will be year 2000 ready, that the authority's year 2000 remediation efforts will be successful in whole or in part, or that parties with which the authority does business will be year 2000 ready.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding year 2000 disclosures, the financial statements referred to above present fairly, in all material respects, the financial position of the Tennessee State School Bond Authority, as of June 30, 1998, and June 30, 1997, and the results of its operations and cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note 6 to the financial statements, the Tennessee State School Bond Authority implemented GASB Statement 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 22, 1999, on our consideration of the authority's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/rm

TENNESSEE STATE SCHOOL BOND AUTHORITY
BALANCE SHEETS
JUNE 30, 1998, AND JUNE 30, 1997

(Expressed in Thousands)

	June 30, 1998	June 30, 1997
ASSETS		
Current assets:		
Cash (Note 2)	\$ 7,988	\$ 11,348
Cash with fiscal agent (Note 2)	2,282	1,232
Investments with fiscal agent (Note 2)	46	227
Principal due from higher education institutions (Note 3)	21,077	20,187
Interest due from higher education institutions (Note 3)	2,062	1,365
Other receivable from higher education institutions	555	296
Total current assets	34,010	34,655
Restricted assets (Notes 2 and 4):		
Crossover refunding investments	8,409	8,416
Debt service reserve	39,153	39,331
Total restricted assets	47,562	47,747
Other assets:		
Advances to higher education institutions - principal (Note 3)	340,172	307,720
Deferred charges	1,114	1,183
Total other assets	341,286	308,903
Total assets	\$ 422,858	\$ 391,305
LIABILITIES AND EQUITY		
Liabilities:		
Current liabilities:		
Accounts payable	\$ 9	\$ 21
Warrants / Wires payable	197	-
Due to higher education institutions	1,509	2,581
Matured bonds and interest payable	1,333	824
Accrued interest payable	2,788	3,081
Notes payable (Note 5)	-	42,095
Commercial Paper payable (Note 5)	91,750	-
Revenue bonds payable (Note 5)	21,077	20,187
Deferred revenue	456	48
Total current liabilities	119,119	68,837
Noncurrent liabilities:		
Net revenue bonds payable (Note 5)	297,619	317,046
Total liabilities	416,738	385,883
Equity:		
Retained earnings, unreserved	6,120	5,422
Total liabilities and equity	\$ 422,858	\$ 391,305

The notes to the financial statements are an integral part of this statement.

TENNESSEE STATE SCHOOL BOND AUTHORITY
STATEMENTS OF REVENUES, EXPENSES, AND
CHANGES IN RETAINED EARNINGS
FOR THE YEARS ENDED JUNE 30, 1998, AND JUNE 30, 1997

(Expressed in Thousands)

	Year Ended June 30, 1998	Year Ended June 30, 1997
<u>OPERATING REVENUES</u>		
Revenue from higher education institutions	\$ 18,120	\$ 18,574
Interest income	3,057	3,464
Net increase in the fair value of investments	1,093	-
Total operating revenues	<u>22,270</u>	<u>22,038</u>
<u>OPERATING EXPENSES</u>		
Interest expense:		
Commercial paper	1,136	-
Revenue notes	893	2,003
Revenue bonds	19,060	18,841
Total interest expense	<u>21,089</u>	<u>20,844</u>
Administrative expense	466	319
Amortization of bond issuance costs	68	179
Total operating expenses	<u>21,623</u>	<u>21,342</u>
Net income	<u>647</u>	<u>696</u>
Retained earnings, July 1	5,422	4,726
Cumulative effect of a change in accounting principle	51	-
Retained earnings, July 1, as restated	<u>5,473</u>	<u>4,726</u>
Retained earnings, June 30	<u>\$ 6,120</u>	<u>\$ 5,422</u>

The notes to the financial statements are an integral part of this statement.

TENNESSEE STATE SCHOOL BOND AUTHORITY
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 1998, AND JUNE 30, 1997

(Expressed in Thousands)

	Year Ended June 30, 1998	Year Ended June 30, 1997
Cash flows from operating activities:		
Net income	\$ 647	\$ 696
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Amortization	68	179
Investment income	(4,150)	(3,464)
Interest expense	21,089	20,844
Interest income	(17,869)	(18,396)
Changes in assets and liabilities:		
Increase in other receivable from universities	(259)	(80)
Increase (decrease) in accounts payable	(12)	21
Increase (decrease) in wires/warrants payable	83	(40)
Increase in matured bonds and interest payable	509	56
Increase in deferred revenue	408	10
Total adjustments	(133)	(870)
Net cash provided (used) by operating activities	514	(174)
Cash flows from noncapital financing activities:		
Proceeds from sale of bond anticipation notes	21,715	14,350
Proceeds from sale of bonds	-	166,378
Proceeds from sale of commercial paper	91,750	-
Cost of issuance paid	-	(248)
Call premium paid	-	(843)
Principal payments - bonds	(20,187)	(75,412)
Principal payments - notes	(63,810)	(76,840)
Interest paid - bonds	(17,860)	(18,360)
Interest paid - notes	(1,025)	(2,065)
Interest paid - commercial paper	(1,136)	-
Net cash provided by noncapital financing activities	9,447	6,960
Cash flows from investing activities:		
Purchases of investments	(78,362)	(47,769)
Proceeds from sale and maturities of investments	79,872	14,522
Interest received on investments	3,106	3,464
Loans issued	(56,144)	(40,225)
Collections of loan principal	24,613	25,739
Interest received on loans	14,644	17,834
Net cash used by investing activities	(12,271)	(26,435)
Net increase (decrease) in cash	(2,310)	(19,649)
Cash, July 1	12,580	32,229
Cash, June 30	\$ 10,270	\$ 12,580
Reconciliation of cash to the balance sheet:		
Cash	\$ 7,988	\$ 11,348
Cash with fiscal agent	2,282	1,232
Cash, June 30	\$ 10,270	\$ 12,580
Noncash financing activities:		
Accretion of capital appreciation bonds	\$ 1,672	\$ 1,773
Bond issuance costs	-	654
Total noncash financing activities	\$ 1,672	\$ 2,427

The notes to the financial statements are an integral part of this statement.

TENNESSEE STATE SCHOOL BOND AUTHORITY
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 1998, AND JUNE 30, 1997

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

The Tennessee State School Bond Authority (the "authority") was created to provide a mechanism for financing capital projects for the state's higher education institutions. The authority is a component unit of the State of Tennessee (the "state") and a separate legal entity. In accordance with the Governmental Accounting Standards Board's (GASB) Statement 14, the authority is discretely presented in the *Tennessee Comprehensive Annual Financial Report* because the authority's board consists of state officials and, therefore, the state has the ability to affect the day to day operations of the authority.

B. Basis of Presentation

The accompanying financial statements have been prepared in conformity with generally accepted accounting principles as prescribed by the GASB. The Tennessee State School Bond Authority follows all applicable GASB pronouncements as well as applicable private sector pronouncements issued on or before November 30, 1989.

C. Measurement Focus and Basis of Accounting

The accompanying financial statements have been prepared using the accrual basis of accounting and the flow of economic resources measurement focus. Under this basis, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

D. Investments

Investments are stated at fair value.

E. Amortized Amounts

1. Bond Issuance Costs. The authority amortizes bond issuance costs using the straight-line method over the life of the bonds. Unamortized bond issuance costs are reported as deferred charges.
2. Bond Discounts, Premiums, and Deferred Amount on Refundings. The authority amortizes bond discounts and premiums using the straight-line method over the life of the bonds. The deferred amount on refundings is also amortized using the straight-line method over the life of the bonds. Bonds payable are reported net of the applicable

TENNESSEE STATE SCHOOL BOND AUTHORITY
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
JUNE 30, 1998, AND JUNE 30, 1997

unamortized bond discount or premium and the unamortized deferred amount on refundings.

3. Interest Accretion. The difference between the face amount of College Saver Bonds (capital appreciation bonds) and the public offering price is not treated as bond discount. Capital appreciation bonds are subject to redemption at prices, which increase from the initial public offering price to the face amount. The carrying amount of these bonds is adjusted semi-annually to reflect the increased liability, with a corresponding charge to interest expense.

NOTE 2. DEPOSITS AND INVESTMENTS

Under the general bond resolution of the Tennessee State School Bond Authority, the funds of the authority can be invested in direct obligations of the United States, or obligations of which the principal and interest are guaranteed by the United States, or certain insured or collateralized accounts. Deposits and investments of the authority meet the requirements of the general bond resolution.

Deposits. The authority's deposits are held in a financial institution which participates in the bank collateral pool administered by the State Treasurer. The securities pledged to protect these accounts are pledged in the aggregate rather than against each individual account. The members of the pool may be required by agreement to pay an assessment to cover any deficiency. Under this additional assessment agreement, public fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure. At June 30, 1998, the authority had \$2,281,840 on deposit with the fiscal agent. At June 30, 1997, the authority had \$844,415 on deposit with the fiscal agent.

The carrying amount of cash on deposit in the State Treasurer's pooled investment fund was \$7,988,228 on June 30, 1998, and \$11,348,546 on June 30, 1997.

Investments. Investments are categorized to indicate the level of custodial risk assumed by the authority at year-end. Category 1 includes investments that are insured or registered or for which the securities are held by the authority or its agent in the authority's name. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the authority's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the counterparty or by its trust department or agent but not in the authority's name.

TENNESSEE STATE SCHOOL BOND AUTHORITY
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
JUNE 30, 1998, AND JUNE 30, 1997

Authority investments at June 30, 1998, are categorized below (expressed in thousands):

	<u>Category</u>		
	<u>1</u>	<u>2</u>	<u>3</u>
U.S. Treasury Notes	\$39,199	\$ --	\$ --
U.S. Treasury Securities-			
State and Local			
Government Series	8,409	--	--
	<u>\$47,608</u>	<u>\$ --</u>	<u>\$ --</u>

Authority investments at June 30, 1997, are categorized below (expressed in thousands):

	<u>Category</u>			<u>Carrying</u>	<u>Market</u>
	<u>1</u>	<u>2</u>	<u>3</u>	<u>Amount</u>	<u>Value</u>
U.S. Treasury Notes	\$39,558	\$ --	--	\$39,558	\$39,609
U.S. Treasury Securities-					
State and Local					
Government Series	8,416	--	--	8,416	8,416
Mutual Funds				388	388
	<u>\$47,974</u>	<u>\$ --</u>	<u>\$ --</u>	<u>\$48,362</u>	<u>\$48,413</u>

From July 1, 1996, through February 7, 1997, the authority had up to \$14.552 million of U.S. Treasury Notes in Category 3 because the securities were purchased and held by the counterparty. Prior to February 7, 1997, up to \$36.7 million in varying amounts was invested in mutual funds.

NOTE 3. LOANS TO HIGHER EDUCATION INSTITUTIONS

The authority and the Board of Trustees of the University of Tennessee and the Tennessee Board of Regents have entered into financing agreements, each originally dated May 1, 1967, and amended and restated as of September 17, 1996, under which the Board of Trustees or the Tennessee Board of Regents, as the case may be, has agreed to construct projects that the authority has agreed to finance. Financing charges payable under the agreement must be sufficient to pay all principal and interest of the notes and bonds of the authority as shall become due.

**TENNESSEE STATE SCHOOL BOND AUTHORITY
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
JUNE 30, 1998, AND JUNE 30, 1997**

NOTE 4. RESTRICTED ASSETS

Advance Refunding Investments. This account represents the proceeds of the 1996 Series C and Series D refunding bonds placed in irrevocable trusts with the fiscal agent for the redemption of the outstanding 1989 Current Interest Bonds maturing in 2020 and the 1990 Series B Bonds maturing in 2004-2011.

Debt Service Reserve. The general bond resolution of the authority requires that the principal of each bond issue include an amount equal to the maximum annual debt service requirements and that such amounts be placed in special trust accounts with the trustee; \$39,153,042 is the sum of such amounts provided at June 30, 1998, and \$39,331,032 at June 30, 1997.

NOTE 5. DEBT PAYABLE

Revenue Bonds. The authority issues revenue bonds to finance capital projects for the state's higher education institutions. The bonds, as well as the notes of the authority, are not general obligations of the State of Tennessee. They are secured by a pledge of the revenues from the facilities for which financing has been provided through the sale of the authority's bonds and notes and by other revenues and resources available to the authority and to the higher education institutions.

Bonds payable, net of unamortized discount, premium, and deferred amounts at June 30, 1998, and June 30, 1997, are as follows (expressed in thousands):

	<u>June 30, 1998</u>	<u>June 30, 1997</u>
Bonds Payable:		
1967 Series A at an interest rate of 4.10% maturing to 2007	\$ 11,015	\$ 12,550
1972 Refunding issue at interest rates of 5.25-5.40% maturing to 2005	18,340	21,890
1976 Series B at an interest rate of 3.0% maturing to 2011	2,715	2,917
1977 Series A at interest rates of 5.40-5.75% maturing to 2006	1,780	2,000
1977 Refunding Bonds at interest rates of 5.40-5.80% maturing to 2011	28,820	31,185

TENNESSEE STATE SCHOOL BOND AUTHORITY
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
JUNE 30, 1998, AND JUNE 30, 1997

	<u>June 30, 1998</u>	<u>June 30, 1997</u>
1985 Series B at interest rates of 5.90-7.0% maturing in 2015	26,385	27,185
1987 Refunding Series A at an interest rate of 4% maturing in 2012	5,250	5,250
1989 Current Interest Bonds at an interest rate of 7% maturing in 2020 and 1989 College Saver Bonds with yields of 6.40-6.9% maturing to 2010 (at accreted value)	27,150	28,838
1990 Series A (Taxable) and Series B at interest rates of 6.7-9.0% maturing to 2011	6,195	6,455
1992 Series A at interest rates from 5.625-6.25% maturing to 2022	40,775	42,475
1996 Series A at interest rates from 5.0-7.0% maturing to 2026	96,290	99,780
1996 Refunding Series B at interest rates from 5.0-6.0% maturing to 2011	48,535	51,415
1996 Refunding Series C at interest rates from 5.375-6.0% maturing to 2020	4,045	4,045
1996 Refunding Series D at interest rates from 5.0-5.5% maturing to 2011	<u>4,400</u>	<u>4,400</u>
Total Par Amount of Bonds Payable	<u>321,695</u>	<u>340,385</u>
Plus Unamortized Premium/Less Unamortized Discount	<u>(771)</u>	<u>(813)</u>
Bonds Payable Net of Unamortized Premium/Discount	<u>320,924</u>	<u>339,572</u>
Less: Deferred Amount on Refundings	<u>(2,228)</u>	<u>(2,339)</u>
Net Bonds Payable	<u>\$ 318,696</u>	<u>\$ 337,233</u>

**TENNESSEE STATE SCHOOL BOND AUTHORITY
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
JUNE 30, 1998, AND JUNE 30, 1997**

Under the terms of the \$27.185 million 1985 Series B Tax-Exempt Exchangeable Securities, on semi-annual payment dates, each holder of the 7% securities may exercise a one-time election to convert to a variable interest rate, not to exceed 10%, as established by an independent municipal securities evaluation service pursuant to a prescribed formula. At June 30, 1998, \$16.95 million of the bonds were held at an interest rate of 7.0% and \$9.435 million were held at a variable interest rate.

Debt service requirements to maturity of the revenue bonds payable at June 30, 1998, are as follows:

For the Year(s) <u>Ending June 30</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
1999	\$ 19,738	\$ 18,417	\$ 38,155
2000	19,397	17,549	36,946
2001	17,706	16,446	34,152
2002	18,398	15,632	34,030
2003	17,172	14,752	31,924
2004-2026	<u>218,438</u>	<u>124,219</u>	<u>342,657</u>
Total	<u>\$310,849</u>	<u>\$207,015</u>	<u>\$517,864</u>

The above principal for revenue bonds is less than that presented on the accompanying financial statements by \$7.847 million. Of this amount, \$10.075 million represents accretion to date of interest on College Saver Bonds in the years preceding the principal payment on the bonds and has been reported as bond principal in the financial statements. It has been reported above as interest in the years (1999-2010) in which the bonds mature. The \$7.847 million also includes \$2.228 million which is a deduction from bonds payable for the deferred amount on refundings and is not reflected in the presentation above.

On April 27, 1998, the Authority approved the Higher Education Facilities Second Program General Bond Resolution. No bonds were issued under this resolution during the fiscal year.

Commercial Paper Program

The Tennessee State School Bond Authority authorized the issuance of \$150 million in Commercial Paper on November 18, 1997, to finance costs of various capital projects. The Commercial Paper also refinanced certain outstanding bond anticipation note indebtedness that the Authority had previously issued to finance costs of various capital projects. The Commercial Paper can be issued either as tax-exempt, taxable or a combination of both. The Commercial Paper dealer is J.P. Morgan & Co. At June 30, 1998,

**TENNESSEE STATE SCHOOL BOND AUTHORITY
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
JUNE 30, 1998, AND JUNE 30, 1997**

the authority had issued and outstanding \$87,500,000 of tax-exempt and \$4,250,000 of federally taxable commercial paper.

The Commercial Paper is a special obligation of the authority. The proceeds of the sale of Commercial Paper may be used to pay the principal of other outstanding Commercial Paper. Commercial Paper principal and interest may be paid from: (i) the proceeds of draws on the *Liquidity Facility*, (ii) *Available Revenues*, (iii) the moneys and securities (if any) on deposit in the Commercial Paper and reimbursement account and in the *Debt Service Fund*, (iv) the moneys and securities (if any) on deposit in the *Project Construction Account* for such projects, and (v) the proceeds of bonds, notes or other evidences of indebtedness to the extent set aside to make such payments.

The maturity of the Paper may not exceed 270 days and the maximum interest rate may not exceed 12%. Upon maturity, the Paper is remarketed by the commercial paper dealer, redeemed, or extinguished with long-term debt.

The liquidity provider, under an *Advance Agreement*, is Union Bank of Switzerland. The total available commitment is \$152,250,000. The commitment fees are 8 basis points on the unused portion of the commitment and 8.5 basis points on the used portion paid quarterly in arrears. The interest rate paid on any *Advance* made by the bank (i) from the *Advance Date* to and including the 30th day following the *Advance Date* is the greater of (a) *Fed Funds* plus 100 basis points and (b) *Prime Rate*; (ii) from and including the 31st day following the *Advance Date* to and including the 90th day following the *Advance Date*, the greater of (a) *Fed Funds* plus 200 basis points and *Prime Rate* plus 100 basis points; and (iii) after the 90th day following the *Advance Date*, the greater of (a) *Fed Funds* plus 300 basis points and (b) *Prime Rate* plus 200 basis points. On any *Business Day* and with the appropriate notice, the Authority may prepay any *Bank Note(s)* issued as the result of an advance without penalty. As of June 30, 1998, no *Advances* had been made under the agreement. The commitment expires at the close of business on November 17, 2000.

Retired Notes Program

Interim and short-term financing for various projects was secured through the Tennessee State School Bond Authority from a Bond Anticipation Notes Program (BANs) through November 30, 1997. The program was established February 24, 1993, with Prudential Securities, Incorporated, as the underwriter and remarketing agent, to fund projects under construction. Under the BANs Program, the final maturity of the notes was March 1, 1998; however, the notes were retired December 1, 1997, and redeemed with proceeds of the Commercial Paper Program. The notes bore interest at a variable rate which was reset weekly by Prudential Securities, Incorporated. Interest on the notes was paid monthly.

**TENNESSEE STATE SCHOOL BOND AUTHORITY
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
JUNE 30, 1998, AND JUNE 30, 1997**

The notes were subject to purchase by the remarketing agent on the demand of the holder on any business day pursuant to the conditions established in the Bond Anticipation Note Resolution as described in the official statement relating to the notes. The remarketing agent used its best efforts to sell the notes to another investor. If the agent was unable to resell any notes that were put, the standby note purchaser was required, subject to certain conditions, to purchase the notes. A standby note purchase agreement was entered into with Union Bank of Switzerland on June 26, 1996, providing liquidity for up to \$105,000,000 principal amount of notes with interest coverage for 34 days at the maximum interest rate of 12%, for a total commitment of \$106,173,699. The authority contracted to pay Union Bank of Switzerland 6 basis points per annum for the used portion and 5 basis points per annum for the unused portion of the commitment. The agreement was extended effective June 26, 1997, through March 1, 1998, based on a reduced maximum available commitment of \$64,523,273. The agreement was canceled, effective December 1, 1997, when the outstanding notes were redeemed.

NOTE 6. ACCOUNTING CHANGE

During the year ended June 30, 1998, the authority implemented GASB Statement 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools," which requires reporting certain investments at fair value. Changes in the fair value of investments (unrealized gains and losses) are recognized as revenue in the operating statement and are not separated from realized gains and losses.

The cumulative effect of this change in accounting principle is reported in the accompanying financial statements as a restatement of the beginning retained earnings. Not all information was available to restate prior periods to conform to this accounting change.

NOTE 7. YEAR 2000 DISCLOSURE

The "Year 2000 Issue" ("Y2K") arises because most computer software programs allocate two digits to the data field for "year" on the assumption that the first two digits will be "19". Such programs will thus interpret the year 2000 as the year 1900, the year 2001 as 1901, etc. Absent reprogramming Y2K affects both computer hardware (i.e., the embedded logic of computer chips) and computer software, and could impact both the ability to enter data in to the computer programs and the ability of such programs to correctly process data. Y2K affects the computer applications and other equipment of the authority and its vendors, investment providers, and bond trustees.

The state has completed its assessment of Y2K and has determined that certain computer applications are mission-critical, certain are critical, and certain are supportive. Mission-critical computer applications are those for which there are no reliable manual alternatives, and for which failure to be in Y2K compliance would prevent the state from

**TENNESSEE STATE SCHOOL BOND AUTHORITY
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
JUNE 30, 1998, AND JUNE 30, 1997**

fulfilling its mission. Critical computer applications are those for which there are manual alternatives, but the State would unlikely be able to fully or efficiently perform the functions manually, because of the volume of manual activity that would be required. Supportive computer applications are those for which there are manual alternatives and the state expects to be able to perform such functions manually, if necessary.

The authority has identified one mission-critical application that is dependent on the state. The authority relies principally upon the State of Tennessee Accounting and Reporting System (STARS) administered by the state's Department of Finance and Administration. As of June 30, 1998, the STARS system had reportedly completed the awareness and assessment stages and was near completion of the remediation stage. The state considers remediation, in this context, to mean either the successful conversion of an existing computer application or the replacement of an existing application with a new application. The state is continuing the remediation and testing of the STARS system. In addition, the state is in the process of assessing the Y2K effect on other equipment. The state is not presently aware of any non-compliance by its yet untested mission-critical and critical computer applications and other equipment or of any costs to achieve Y2K compliance that will have a material negative impact on the state's operations or financial status; however, the state can give no assurance that circumstances will not change.

The authority Y2K initiatives did not result in the commitment of significant financial resources as of the end of the authority's reporting period.

The state has begun soliciting information from other organizations whose Y2K compliance could affect the state regarding the status of their assessment, testing and remediation of their computer applications and other equipment. Of the organizations that have responded to date, all expect to achieve compliance in a manner that will not have a materially negative effect on the state's operations or financial status although no assurances can be given that circumstances will not change. The state does not have full and complete information, however, from these other organizations regarding the status of implementing Y2K compliance. Any failure by some or all of these organizations to be in Y2K compliance may have a material negative impact on the state's operations or financial status.

NOTE 8. CONTINGENCY

The authority has incurred a contingent arbitrage liability of \$40,133.

NOTE 9. SUBSEQUENT EVENTS

On October 1, 1998, the authority issued four series of bonds. The bonds were issued under the Second Program Bond Resolution approved by the authority on April 27, 1998. As a result of the approval of the resolution, the authority's bonds were upgraded

TENNESSEE STATE SCHOOL BOND AUTHORITY
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
JUNE 30, 1998, AND JUNE 30, 1997

to a rating of Aa₂ by Moody's Investors Service and AA+ by Standard & Poor's Rating Group.

The 1998 Series A Bonds in the amount of \$54,865,000 were issued to redeem \$43,600,000 of the authority's tax-exempt Commercial Paper and to pay the construction costs of certain projects. The 1998 Series B Bonds (Federally Taxable) in the amount of \$15,460,000 were issued to redeem \$2,200,000 of taxable Commercial Paper and to pay the construction costs of certain projects.

The 1998 Series C Bonds in the amount of \$48,735,000 were issued to current refund all of the outstanding 1972 Series Refunding Bonds, the 1977 Series A Bonds, the 1977 Refunding Bonds and the 1985 Series B Bonds. The 1998 Series D Bonds in the amount of \$33,540,000 were issued to advance refund portions of the 1992 Series Bonds. Simultaneous with the issuance of the new Bonds, the authority issued \$21,800,000 of taxable Commercial Paper to refund the University of Tennessee Hospital projects included in the refunded Bonds. The Commercial Paper was issued in preparation for the conversion of the hospital to a 501(c)(3) corporation.

On January 7, 1999, the authority amended the Commercial Paper Resolution to increase the maximum size of the Commercial Paper Program from \$150,000,000 to \$200,000,000.

On January 14, 1999, the authority had outstanding \$67,600,000 in tax-exempt and \$35,850,000 in federally taxable Commercial Paper Notes. Between June 30, 1998, and January 14, 1999, the authority has issued \$35,700,000 in Commercial Paper to pay construction expenditures.